In September 2015, we traveled to Sydney and Melbourne to meet with several of the major Australian bank issuers, including Commonwealth Bank of Australia, Westpac Banking Corp, Australia and New Zealand Banking Group Ltd., National Australia Bank and Bank of New Zealand. We also had the opportunity to meet with Moody's Australia to discuss the Australian banking sector and sovereign landscape.

With nearly $130b of commercial paper (CP) and Yankee certificate of deposits (YCDs) representing approximately 5.5% of all prime money market instruments outstanding, the Australian banking sector continues to be an important investment option for Dreyfus money market funds.

Our discussions with the issuers and Moody's focused on the Australian economy and possible implications from the slowdown in China, the Australian housing market, recent Australian bank performance, the regulatory landscape and funding plans. We came away with the sense that the Australian banks continue to maintain a safe-haven status driven by a favorable operating environment, conservative underwriting practices and robust regulatory oversight by APRA, which collectively have fostered consistently good profitability, sound asset quality and strong capital adequacy. So far, the slowdown in China and the commodities sector has been a moderate drag on economic growth in Australia with minimal impact on the Australian banks given limited direct exposure to either sector. However, the ability of policy makers to combat the aforementioned headwinds will be a key issue in maintaining investor confidence given the importance of international wholesale funding for the Australian banks. All in all, the trip was constructive and reinforced our conviction that investing in the Australian banking sector is consistent with minimal credit risk.

Australia's economy has expanded for 24 consecutive years and was one of the few advanced economies to avoid a recession during the global economic downturn that ensued post the financial crisis. The key to Australia's success over this time period has been strong demand for its vast wealth of natural resources such as iron ore, copper, gold and liquid natural gas — particularly from China, which is Australia's largest trading partner accounting for 28% of net trade. As a result, the resource sector has doubled in size to provide nearly 9% in value added to Australia's GDP while accounting for approximately two-thirds of GDP growth. Going forward, the Australian economy faces challenges as foreign direct investment in the mining sector has peaked in conjunction with a slowdown in China, which has contributed to significant pressure on commodity prices. To combat these challenges, the RBA has cut its main policy rate several times to 2% currently, while the free-floating exchange rate has acted as an additional shock absorber by allowing the Australian Dollar to depreciate by 20% relative to the USD. Australia also benefits from a flexible labor market as evidenced by early signs of solid growth in construction and service-related jobs to offset a sharp decline in mining-related jobs such that the unemployment rate has held steady at 6.2% as of August 2015. So far, Australia's economy has continued to display resiliency, with the IMF's recent growth projections estimating GDP growth of 2.4% in 2015 followed by 2.9% in 2016, which is moderately below Australia's trend growth rate of 3%. The major banks we met with do not envision a hard landing in China (defined as GDP growth below 5%) with most in the camp of 6.3% to 7.0% GDP growth, which is in line with the IMF's recent projections for China. Australia continues to benefit from AAA ratings with stable outlooks across the board given the strength of its diversified economy, low level of government debt and fiscal capacity that would allow for stimulus if needed. The housing market is of particular importance to the Australian banks, with primary residential and investment property mortgages representing approximately two-thirds of the lending portfolio. While house price appreciation has been rampant in Sydney and Melbourne, growth has been much more subdued in other areas of the housing market. Population growth, a general undersupply in housing relative to demand and an increase in foreign investment has largely fueled the increase in house prices. Growth in house prices does not appear to be credit-fueled, as residential mortgage lending...
growth was roughly 7% y/y. That said, there has been a noticeable increase in interest-only investment property lending in Australia to the point where regulators have instituted a cap on investment lending growth at 10% per year in order to stave off a potential asset bubble. On that note, the IMF in its recent assessment viewed the Australian housing market as being slightly overvalued by about 10%. While full recourse lending, no tax deductibility on primary residence and the requirement of private insurance on loans with a LTV above 80% have long been structural features of the Australian mortgage market, APRA recently increased the risk-weight on mortgages to 25% to force banks to hold higher levels of capital against the mortgage book. Another strong feature of the Australian mortgage market is that more than 98% of mortgage assets are held on bank balance sheets with less than 2% securitized, thus giving banks skin in the game. Despite consumer debt being relatively high at more than 1.5x disposable income, mortgage loan performance has remained quite strong, with average LTVs below 50%, credit costs in the low single basis point range and mortgage prepayments extending beyond two years. With per-capita income being amongst the highest in the world at $61,000 according to the IMF, the household saving rate at roughly 9% and unemployment holding steady at 6.2%, we continue to view the Australian consumer as having high capacity to service its debt.

The Australian banking sector has consistently been amongst the most profitable globally, with the four major Australian banks posting an average ROE (return on equity) of 15.7% for the period ending 6/30/15, in line with recent performance. This has been achieved despite lackluster revenue growth, which has been constrained by net interest margin compression, modest credit growth of 5% y/y including the mortgage related book, impact of adverse weather-related events on insurance operations and flat revenues in institutional banking and capital-markets businesses. In general, performance in the retail and commercial banking activities in both Australia and New Zealand continue to be strong. Overall profitability has been supported by strong efficiency ratios due to productivity enhancements and cost-control measures while benign credit conditions have resulted in very low credit costs at 0.18% of loans on average. Direct exposure to China is negligible while exposure to the resource-related sector is very limited at less than 2% of loans; however, some banks have increased provisions toward this sector. Non-performing assets have continued to trend lower and represent less than 60 basis points of total loans on average.

The four major Australian banks collectively raised $11.1b in capital following the July 2015 decision by APRA to increase the risk weight on Australian residential mortgages to 25% effective July 2016. As a result, the average CET1 ratio increased to 9.8% on average under the more conservative APRA rules, or 13% if harmonized international Basel III standards were applied. The increase in mortgage risk weights was one of the recommendations of the Australian Government’s Financial System Inquiry that called for Australian bank capital ratios to be in the top quartile amongst international banks. In our discussions with the banks, some expressed the idea that the risk weight on mortgages could be raised to 30% while additional buffers for the D-SIB banks could be imposed as a way to improve Australian banks’ loss-absorbing capacity further without needing to adopt a bail-in regime as has been the case in Europe and North America.

Liquidity profiles for the Australian banks appear solid, with the four major banks posting an average liquidity coverage ratio of 118% for 6/30/15. Given the lack of government debt in Australia, half of the eligible liquid assets come from the RBA’s Committed Liquidity Facility, which accepts self-securitized mortgages as collateral. Since the financial crisis, Australian banks have experienced good deposit growth in excess of more subdued lending growth. As a result, loan-to-deposit ratios have improved while dependence on wholesale funding has declined from approximately half of total funding to slightly over a third. At the same time, the Australian banks have been terming out their wholesale funding books, with short-term wholesale borrowing now accounting for about 15% of total funding.
Investors should consider the investment objectives, risks, charges and expenses of a money market mutual fund carefully before investing. Contact your BNY Mellon Fixed Income Representative to receive a money market fund prospectus, or a summary prospectus if available, that contains this and other information about a money market fund, and read it carefully before investing.

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